EXECUTIVE SUMMARY

Financial turmoil was prevalent throughout the 1990s. Financial crises broke out in Europe, Latin America, and Asia.

- In Europe, German economic and monetary mistakes sharply clashed with a flawed process leading to European economic and monetary unity.
- In Latin America, a high current account deficit and a rigid exchange rate regime in Mexico promoted financial chaos and a chaotic collapse of the peso.
- Similarly, high current account deficits and rigid exchange rate regimes contributed to financial turbulence and a disorderly free-fall of Asian foreign exchange rates.

Floating exchange rate regimes are needed to optimize free international capital markets.

Meanwhile, Asia's economic roller coaster shows no signs of stopping. The past five years have seen an economic crisis in 1997, recession in 1998, a bounce-back in 1999/2000, and a downturn and recession in 2001. Much of the Asian bounce-back reflected a surging U.S. economy in 1999 and 2000. But the fuel for this U.S. growth disappeared in 2001 when the global information technology (IT) sector went from boom to bust. During the boom too many Asian economies became complacent and avoided painful structural reforms. That made them increasingly vulnerable to the U.S. recession and global slowdown. Asian states will remain economically insecure until they become more serious about implementing structural economic reforms.

The terrorist attacks of 11 September 2001 worsened an already weak U.S. and global economy. After 9-11, the USG faced economic issues on at least three fronts: reconstruction in New York City, fighting recession at home, and using economic diplomacy to help the U.S. coalition in the war on terrorism. All three issues required immediate crisis action. But a long-term strategy in each area is also needed to put the United States and the global economy on a sustainable path toward long-term economic growth.

While the events of 9-11 provide common lessons learned for all the countries in the region, each country also faces problems unique to their social and political context. For instance, Australia made painful economic reforms throughout the past decade that helped the country weather the global economic storm with positive economic growth. But recent actions against foreign corporations has discouraged foreign investors and weakened the Australian dollar.

While Bangladesh still struggles with poverty, the country has also made considerable progress over the past three decades. For instance, Bangladesh is now largely self-sufficient in food production. But the country could do even better if it would improve its economic governance.

Despite strong oil sales, Brunei remains over-centralized and suffers from a lack of foreign investment in other sectors of the economy. The economy is on a recovery path as the government moves ahead with economic reforms. In contrast, Cambodia is one of the poorest countries in the world and continues to struggle. Its 4% growth rate is insufficient to make a dent in the poverty rate. Foreign aid continues to prop up the economy. But donor fatigue will set in soon and economic growth will suffer unless Cambodia gets more serious about military demobilization and economic reform.

China's economic fate is uncertain. China's WTO entry has attracted billions of dollars in foreign direct investment. Coastal commerce is booming. But state owned enterprises and the politicized banks that give them credit are like financial quicksand, dragging down the economy as a whole. The banking system would be bankrupt were it not for government largess. Unfortunately, the upsurge in government spending is not durable. The day of reckoning for decades of financial mismanagement will soon arrive unless private demand picks up.

Meanwhile, 9-11 shocked the Indian economy, although not as much as with some Asian economies. Growth continues to slow, unemployment is rising, and corporations are going out of business. Strength in the agriculture and other domestic sectors should help a resilient Indian economy weather the ongoing economic downturn. Unfortunately, India shows no signs of addressing an alarming budget deficit that is triggering a fiscal crisis. If India is ever to reduce poverty, it must also become more serious about implementing economic reforms.

Meanwhile, President Wahid's departure and President Megawati's new economic blueprint raised expectations that Indonesia could start digging itself out of a deep economic hole. But the global recession and 9-11 shattered Indonesian exports and prospects for immediate growth.

After a decade of economic stagnation, the arrival of charismatic Japanese Prime Minister Koizumi provided a glimmer of hope that economic reform could finally take place. But the combination of a serious deflationary spiral and relentless structural problems are daunting. Reckless allocation of money over the years has created a mountain of bad bank loans. In addition, the Japanese government is running a financially unstable public sector debt of 130% of GDP. Such financial quicksand is a weak foundation for long term economic growth in Japan.

The economic situation in Laos is also grim, with Western economic assistance propping up a socialist government that shows no signs of implementing free market reforms anytime soon.

After robust growth in 2000 the Malaysian economy was virtually flat in 2001. A rigid exchange rate regime coupled with weak demand for Malaysian exports means that an overvalued ringgit is vulnerable to a sharp free-fall and financial turmoil.

While the government in the Maldives is starting to consolidate its fiscal position and address economic reform, the country remains vulnerable to external shocks because of the sluggish tourism and fishing sectors.

Mongolia's poverty-ridden economy continues to struggle despite the peaceful transfer of power in 2000. What's missing is the critical software of society—free market laws and institutions.

North Korea's overall economic performance remains unimpressive. Agricultural production has fallen sharply and famine is possible. While there is some evidence of growth in the non-farm sector, North Korea's economic performance will be marginal at best without more decisive DPRK actions to implement a free market economic strategy. While continued donor largess is needed to keep the economy afloat, IMF and World Bank advice and assistance is also needed to move the DPRK economy in the right direction.

In the Philippines, weak external demand for Philippine exports is slowing down economic growth. A ballooning budget deficit, a large foreign debt and dangerously low currency reserves provide a weak foundation for poverty reduction and undermine the capability to fight the war on terrorism.

In Russia, President Putin has the Russian economy moving in the right direction. After a painful default in 1998 and subsequent economic downturn, three drivers—the currency devaluation, oil wealth, and structural reform—have given the Russian economy a boost.

Singapore fell into recession in 2001—its worst contraction since its independence in 1965. The crucial U.S. market for Singapore's high tech exports has totally collapsed. In addition, the weaker investment in the rest of Southeast Asia is also hurting Singapore's growth prospects.

The U.S. and global recession as well as 9-11 has sharply reduced South Korea's trade surplus and triggered a painful economic slowdown. An ill-advised U-turn on corporate reform leaves the chaebol bloated and a painful drag on long term economic growth.

Sri Lanka remains a classic case study showing the interdependence between military security and economic stability. Since military escalation in 2000, a war zone atmosphere has made economic prosperity difficult. At the same time, a weak economy makes it difficult for the government to manage the war effort.

Taiwan suffered its first full-year contraction in at least half a century. Taiwan now faces three difficult economic challenges—a global IT glut, structural fault-lines (especially a broken financial system), and the mainland's investment pull (which is hollowing out the manufacturing sector).

The collapse of the U.S. appetite for Thai exports has triggered a serious downturn in the Thai economy. The most urgent problem facing the economy is a mountain of bad loans, which are dragging down the financial system. An over-borrowed public sector makes it difficult to address the banking problems.

Vietnam's economic performance remains well below its potential. Slow economic reforms continue to discourage foreign investors, which in turn keeps economic growth sluggish.

The good news is that the U.S. and global economy appear to be bottoming out. The bad news is that weak U.S. corporate earnings and a collapse in U.S. capital spending mean that it is still too early to say that a speedy and robust U.S. recovery will take place anytime soon. In this regard, the recent Enron debacle and the shoddy accounting at Arthur Anderson have undermined confidence in the U.S. business culture, thus delaying still further a U.S. recovery. Finally, a sluggish U.S. recovery weakens prospects for a strong Asian recovery in 2002.

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